Internal Revenue Service

memorandum

CC:TL-N-8534-89
Brl:DLFischer

date: SEP 20 1989

to: District Counsel, San Jose CC:SJ
Attn: Steven J. Sibley

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted] v. Commissioner
Docket No. [redacted]

This is in response to your request for technical advice which was addressed to the Chief, Tax Shelter Branch, dated July 10, 1989.

ISSUE

Whether a huge tax revenue loss would occur if the government prevailed in the above case on the issue of petitioner's failure to allocate to warranties a portion of the purchase price of [redacted].

CONCLUSION

It is unlikely that a government win in this case would result in the tax revenue loss that petitioner projects. Revenue warranties such as those acquired by petitioner for his [redacted] equipment are not generally acquired by traditional utilities companies. In addition, petitioner's calculations in reaching his projected tax loss are faulty.

FACTS

This case involves the purchase of [redacted] which were promoted by [redacted]. During the recently concluded trial, the respondent's position was that petitioner had improperly allocated the full purchase price to the basis of the tangible assets. Respondent argued that part of the purchase price should have been allocated to the production warranties received by petitioner. The effect of such an allocation would be to remove that amount from the basis of the tangible property, and thereby reduce the amount of the investment tax credit and depreciation. The petitioner would, however, be able to depreciate the amount allocated to the warranty over the life of the warranty.

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By letter dated [redacted], petitioner's attorney argued to the District Counsel attorney that if the government wins this issue, it can result in an annual revenue loss of $[redacted]. This figure was arrived at as follows:

> If one assumes that the same relative effect as is applicable to the typical power plant ($[redacted] revenue loss per $[redacted] invested) applies to [redacted]% of the $[redacted] of property placed in service each year (with the $[redacted] figure calculated as twice the $[redacted] revenue gain from the capital cost provisions of the Tax Reform Act of 1986 for 1987-91), the annual revenue loss throughout the U.S. economy is $[redacted], divided by $[redacted], multiplied by $[redacted], or $[redacted]. This is, of course, an extremely rough calculation. However, it indicates the rough magnitude of the effect.

[redacted] letter at p.A-4.

DISCUSSION

Public utility property is treated as recovery property for purposes of ACRS if the taxpayer uses a normalization method of accounting, and the rates for furnishing its services are established or approved by a state or federal agency or instrumentality or subdivision thereof. Public utility property is categorized as either ten year property under section 168(c)(2)(C)(i) or fifteen year property under section 168(c)(2)(E). See Prop. Treas. Reg. § 1.168-3(c)(3) and (5). Windfarm equipment such as taxpayer's is treated as five year property under section 168(c)(2)(B).

Taxpayer assumes, as part of his calculation, that public utilities acquire property with revenue warranties similar to those at issue in the instant case. If that were true, and similar allocations to the warranties on such property were made, a portion of basis that was being depreciated over a ten or fifteen year period would be depreciated over a five year period. Thus, the utility company taxpayer would lose ITC but, at the same time, would receive a shortening of the period for depreciating the warranty portion. An enormous revenue loss would result from the acceleration to a five year write off from a fifteen year write off of the warranty portion of the price of utility industry equipment.

Taxpayer's hypothesis is faulty in the following respects. First, revenue and output warranties are not prevalent in the utilities industry. We are advised by Don Burkhart, IRS Utilities Industry Specialization Program, Akron, Ohio, that conventional large power plants, such as those owned by [redacted], etc. are mostly self-constructed. Equipment that is purchased by such companies undergoes extensive preoperational testing. Instead of output warranties, the power companies use retainages to protect against performance problems. That is, the utility companies retain a portion of the purchase price until it is demonstrated that the equipment meets the specific performance levels.

Second, utilities build or expand their capacity based on demands. They need no special inducement to purchase equipment because they are already assured, through extensive ratemaking procedures and supply and demand projections, that consumers will repay the cost of new equipment. Small investors, however, like purchasers of interests in [redacted], do not have the same level of industry experience or consumer demand upon which they can rely. We note that we do not have all of the facts of the case at hand, and, thus, we are not advising whether or not an allocation of a portion of the purchase price to warranties is appropriate in this particular case. However, based on the advice of our industry specialist, we do not think it is likely that our position in this case will result in an enormous revenue loss based upon its application to the general utilities industry. We note also that due to the nature of the [redacted] equipment, [redacted] are climatically restricted to [redacted]. There may be a number of small power companies that acquire warranties similar to taxpayer's; however, they apparently do not constitute a significant share of utilities industry property.

Moreover, taxpayer's calculations are questionable. We have not undertaken a detailed analysis of taxpayer's computations, since we do not feel that the [redacted] reallocations are applicable to the industry. However, taxpayer based his projections of revenue loss on a [redacted] percent tax bracket, instead of the corporate tax rates. Taxpayer apparently omitted from his calculation the step which multiplies the last number by [redacted], to reflect the power plant portion of the property placed in service each year. Adding that calculation to taxpayer's computation would reduce taxpayer's result to $[redacted], from $[redacted].

CONCLUSION

Based on the foregoing discussion, we are not persuaded by taxpayer's contention that winning this case would result in a significant revenue loss.

If you have any questions, please telephone Debra Fischer at FTS 566-3521.

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